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NOTES

WASHINGTON NOTES

INCREASE OF FEDERAL RESERVE MEMBERSHIP

One of the most interesting results of the war in its effect upon American banking has been the notable increase in the membership of the Federal Reserve system. The movement of state institutions into the system had begun immediately after the adoption of the act of June 21, 1917, amending the Federal Reserve act. By this amendatory law there was given to state institutions a distinct legislative pledge that they would not, by taking membership in the system, sacrifice any of their charter powers. This guaranty was made further influential by an opinion of the Attorney-General of the United States, September 10, 1917, interpreting the new measure in such a way as to release state bank members from the effects of the so-called "Clayton Act," and "Kern Amendment" thereto, which had been intended to prevent the continuance of what have been called "interlocking directorates." State institutions which become members may thus continue their directorates upon the old basis without more disturbance than they would suffer were they not to become members.

The movement into the system, although stimulated by this new legislation and interpretation, continued only moderate during the summer months. Pressure of war financing, and the certainty of conditions requiring collective action on the part of the banks, afforded a more powerful impetus; and, with the opening of the second great loan campaign on October 1, the disposition of many large trust companies to enter the system crystallized in action. A further influence was afforded by an open letter addressed by the President to state institutions generally and issued on October 13. In this letter the President used the following language, appealing directly to the patriotism of the state bankers:

May I not, . . . , urge upon the officers and directors of all nonmember state banks and trust companies which have the required amount of capital and surplus to make them eligible for membership, to unite with the Federal Reserve system now and thereby contribute their share to the consolidated gold reserves of the country? I feel sure that as member banks they will aid to a greater

degree than is possible otherwise in promoting the national welfare, and that at the same time, by securing for themselves the advantages offered by the Federal Reserve system, they will best serve their own interest and the interest of their customers. I believe that co-operation on the part of the banks is a patriotic duty at this time, and that membership in the Federal Reserve system is a distinct and significant evidence of patriotism.

The outcome of all these influences has been seen in an increase of membership up to October 27, which brings the total capital and surplus of the state members (including those approved for membership but not finally admitted) to about \$274,000,000 and their total resources to nearly \$3,000,000,000. This gives the system from 68 to 70 per cent of the entire banking resources of the country, while it must be remembered that of those not yet included a large proportion are ineligible, either because of the smallness of the individual capitals or for some other reason. It may thus be fairly said that the Federal Reserve system includes today the essential banking resources of the country and represents the collective reserve strength of the nation.

PROGRESS OF PUBLIC FINANCING

The closing of the second "Liberty Loan" on October 27 adds another chapter of unprecedented interest to the financial history of the United States, and shows the immense financial strength of the country in a light never before thrown upon it. Success in placing this loan adds an issue of \$4,000,000,000 of bonds shortly to be outstanding to the previously issued \$2,000,000,000 of war bonds and the old national debt still in private bonds before the war. The new issue raises many financial questions of profound interest never before presented.

Chief among these new problems is the relation of the reserve banking system to public finance. Figures for the operation of the reserve banks, up to almost the close of the loan on October 27, show an increase in their holdings of discounted paper up to \$272,000,000 protected by government obligations. These constitute about 70 per cent of all discounts. The resources of the system have thus been drawn upon in the course of the financing to only a very moderate extent; and the hope is that, during the coming months, before the placing of any new issue, it will be possible to transfer to the public the interest in the new securities represented by the rediscounts of member and non-member banks secured by government obligations.

The first loan had a notably satisfactory result in this respect, but a small amount of such rediscounts remaining in the hands of the banks

at the end of thirty days from the conclusion of the operation. Probably the process of transfer will be less speedy on the present occasion, but it will undoubtedly progress steadily. Meantime the notable feature of the financing is seen in the steady issuing of the short-term certificates of indebtedness put out by the Treasury as a means of meeting current needs. These short-time certificates have operated to provide a means whereby the funds of the community have been regularly drawn off for public use, without any dangerous congestion or unavailability of funds such as would inevitably have occurred under the old subtreasury system. The certificates of indebtedness, being made payable at any Federal Reserve bank through which they were purchased, and being held chiefly by banks as a short-time investment, afforded a means of providing exchange for use in paying the subscriptions to long-term bonds. Certificates were thus tendered to Federal Reserve banks in payment for bonds subscribed by banks and their clients, while the funds resulting from purchases both of certificates and bonds were left on deposit with the institutions through which the subscriptions were placed until actually needed to meet government obligations. The whole process has thus been smoothed and made as nearly free from friction as would be possible in so inclusive an operation. This effort to ease the effects of the borrowing is the more necessary because of the increase of tentative estimates of outlay for the current year to nearly \$20,000,000,000, while available sources of taxation at their maximum yield will produce not to exceed one-fifth of that sum, and probably an amount materially below it.

Thus far, the chief direct and visible results of the war financing upon financial conditions in general have been (1) increase in the rates of interest paid by private enterprises for both short- and long-term capital and accommodation, (2) withdrawal of private buying support from the usual investment markets, and hence reduction or downward tendency of security prices, and (3) changes in the character of business at banks, industrial enterprises being paid in "cash" for government orders while this cash is obtained through the borrowing process already described.

THE GOLD "EMBARGO"

Incident to the effects of the war financing has been a movement of gold out of the country amounting during the year thus far to more than \$100,000,000 net. This exportation has been due to a variety of factors, among them the disturbances of foreign exchange, which have

produced conditions in neutral countries favorable for arbitrage operations. Other influences have been found in the existence of unfavorable balances of trade with various countries, which in former days would have been settled by triangular exchange adjustments involving some third nation with which our balance was favorable. Special importations due to war requirements have in some cases increased this unfavorable balance.

The movement of gold had, by September 7, reached proportions which called for action, and on that date the President consequently issued his Executive Order and Proclamation vesting in the Secretary of the Treasury authority (derived from the act of June 15, 1917) to regulate the movement of "coin, bullion, and currency." This authority had been exercised through the Federal Reserve Board, and gave rise to the instructions or regulations, issued on September 21 by that body, for the control of these movements.

The regulations thus issued contained three chief elements: (1) a limitation upon the amount of gold to be taken abroad by travelers to \$200 for each adult; (2) an announcement that shipments of foreign and domestic paper currency (except good certificates) would ordinarily not be interfered with; and (3) the statement of a policy with respect to gold expressed as follows:

It will be the general policy of the Board not to authorize the exportation of gold unless the shipment applied for is shown to be connected in a direct and definite way with a corresponding importation of merchandise for consumption in the United States, but in any case authorization will be granted only where the exportation of gold in payment for such merchandise is found to be compatible with the public interest. In reaching its conclusion, however, the Board will consider all attending circumstances in each particular case.

It is the latter point that is of chief interest in this connection, because it lays down in a concrete way the idea that shipments of gold must be sanctioned chiefly as a direct return for merchandise. This, of course, is a departure from the usual conditions obtaining in international trade, where gold is ordinarily shipped to settle balances growing out of large merchandise movements and corresponding to no particular consignment. The new policy tacitly implies that the real purpose in view is that of controlling *trade*—that is to say, of judging from definite data whether or not a given proposed transaction is "compatible with public interest," because the goods to be purchased are needed in the maintenance of national welfare. Other transactions may evidently

continue if foreign sellers are willing to accept payment in some form of credit—securities, bank credits, or government obligations.

International trade is thus put upon an entirely new, and conceivably very restricted, basis, inasmuch as entirely new and much narrower modes of settlement or payment are left open. This would be true even without the strict control of merchandise exports and imports which is being exercised under the "Trading with the Enemy" act. By way of completing and rendering effective the embargo, the Federal Reserve Board has requested banks not to "earmark" gold. This practice of earmarking has been common in recent years, due to the desire of foreign banks to establish special trust funds on deposit with American banks, which could then be used as a basis for the issue of notes or for other purposes. The effect of such earmarking is to hoard the gold so used, and thus to withdraw it from employment as a banking reserve. The change in methods resulting from the embargo and the prohibition of earmarking thus necessitates an alteration in the habits of the foreign institutions which had resorted to this mode of dealing with gold in the United States.

CONTROL OF INTERNATIONAL TRADE

Complementary to the gold embargo is the almost complete control of international trade established by virtue of the so-called Espionage act (June 15, 1917), coupled with the "Trading with the Enemy" act (Oct. 5, 1917). Taken together, these two acts provide entire control over both importation and exportation—functions now vested in the "War Trade Board" by the President's proclamation made public on October 15. A license system under which permission both for importation and shipment of goods is necessary is being gradually developed; and it may be expected that at an early date there will be a thorough control of foreign trade. This should eventually solve the "gold problem" in the really effective way—by cutting off trade except in those articles in which business is actually desired.

The control thus exercised cannot be expected to exert the same influence as in Europe, owing to the great extent and industrial scope of the United States which permits the manufacture within our own borders of practically every consumable commodity, or of some more or less satisfactory substitute therefor. Control of transportation, through a system of "priorities" already in operation and through the power to direct the distribution of coal, may largely accomplish in domestic business what the system of international trade oversight just sketched

will do in foreign trade. All in all, a very powerful grasp upon business both in volume and direction has been established; and of this the best exemplification is seen internationally. Taken in conjunction with the fact that both the building and operation of ships are practically in the hands of the government, the new powers of restriction and oversight virtually enable the government to direct our industrial powers as it chooses. The immediate consequence of this situation is undoubtedly to be that of reducing the commanding position we had been rapidly acquiring in international commercial affairs, since our powers will now be chiefly addressed to the task of providing war material. It would seem inevitable that the flourishing foreign trade which had fallen into our hands in so many branches should now decline in scope, due to the diversion of our energies and attention, as well as of all available means of transportation, to other fields of work. This may, however, be accomplished with less or more disturbance to underlying business conditions according to circumstances and the wisdom and skill of methods of administration. These are still to be developed in their full application.